With the gap between the highest marginal and company tax rates to increase what can we expect for Division 7A?

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Introduction

The 2016/17 Federal Budget proposals to reduce the corporate tax rate are welcomed by some and pilloried by others. The economics can be debated: does this just amount to a handout to the corporate world or will it stimulate the economy, encourage foreign investment and ultimately benefit all Australians?

Some things are undeniable however. A cut in the corporate tax rate particularly benefits foreign shareholders and, even, foreign government revenues. The so-called complementary extension of the unincorporated small business entities (SBE) tax discount is in no sense complementary to the company tax rate cut. The widening of the gap between the company tax rate and the highest marginal rate for individuals focuses further interest on the proposed Division 7A amendments. This article addresses these realities.

Reduction in the (SBE) corporate tax rate and lowering of the SBE threshold

The 2014/15 and 2015/16 Budgets resulted in a reduction in the SBE corporate tax rate to 28.5% from 1 July 2015. The 2016/17 Budget measures now propose to increase the annual turnover threshold for SBE income tax concessions from less than $2m to less than $10m. This will mean that a further 90,000 companies will be able to access existing SBE income (but not CGT) tax concessions from 1 July 2016. Most significantly, these concessions include the lower SBE corporate tax rate, which itself will be reduced to 27.5% from that date.

As an aside, the SBE concessions also includes the instant asset write off threshold of $20,000 available until 30 June 2017. Entities that are now to fall within the new SBE threshold from 1 July 2016 might, therefore, consider deferring the acquisition of capital assets below $20,000 until after that date to ensure immediate deductibility.

Much has been made of this increase in the threshold with opponents suggesting that companies approaching a $10m turnover are not small businesses whilst proponents argue that the threshold has been around for years and, having never been increased, should be adjusted up. In fact, the SBE rules and their threshold date from 2007 (although based on the STS rules introduced in 2001). Upon the name change in 2007 the annual turnover threshold in the eligibility test increased from $1 million to $2 million. Had the threshold been indexed from 2007 it would be around $2.5 million in today's terms.

In any event, for the purposes of access to the lower company tax rate (at least) the $10m threshold is not to be relevant for long. The threshold to access the 27.5% tax rate will be progressively increased to, ultimately, have all companies at that rate by the 2023/24 income year as follows:

Income year	**Annual turnover threshold**
2017/18	$25m
2018/19	$50m
2019/20	$100m
2020/21	$250m
2021/22	$500m
2022/23	$1b
2023/24	None

Query whether access to the other SBE tax concessions will also extend to this greater category of entities or whether these increases in the threshold are solely for the purposes of accessing the lower company tax rate.

The company tax rate will be further reduced progressively from the 2024/25 income year as follows:

Income year	**Company tax rate**
2024/25	27%
2025/26	26%
2026/27	25%

In contrast to the 2014/15 and 2015/16 measure reducing the SBE company tax rate, the Budget papers state that the franking credits will be able to be distributed in line with the rate of tax paid by the company making the distribution. What this means is unclear. Does it mean that the maximum franking credit attached to any particular dividend would be determined by reference to the corporate tax rate at the time the dividend is paid? If so this could lead to excess franking credits from earlier (higher company tax) years that cannot be allocated to any dividends. Alternatively, is there a suggestion that we may return to the days of franking credits A and B that existed prior to the current iteration of the imputation rules?

Irrespective, the benefit of the company tax rate will, for many resident shareholders, be illusory. Those facing marginal tax rates in excess of the company tax rate will simply pay more personal tax on dividends carrying less franking credits. Whilst private companies might decide to retain more profits to avoid this “top up” tax for their shareholders this might not be such a feasible proposition for public companies. Foreign shareholders though are big winners given that more company profits will exist after tax able to be paid as fully franked dividends on which no withholding tax is payable. Even then this may mean that they have less foreign tax credits to offset against tax payable in their home country so the ultimate winners may, indeed, be the treasuries of foreign governments.

As for Australia, the government (eventually) revealed that the cost to the budget over 10 years of the reduction in the company tax rate is estimated at $48 billion.

Unincorporated small business tax discount increased

Introduced in the 2015/16 Budget as a 5% discount on tax paid by unincorporated SBEs, this measure was stated to complement the reduction in the SBE corporate tax rate. Using the same rationale, the discount is to increase over ten years to 16%. First increasing to 8% on 1 July 2016, the discount will be available to individual taxpayers with business income from an unincorporated business that has an annual turnover of less than $5m up, from the $2m threshold. With this last change there are now three different small business thresholds depending on the concession at issue!

More particularly, the tax discount will be increased as follows:

Income year	***Discount rate***
2016/17 to 2023/24	8%
2024/25	10%
2025/26	13%
2026/27 and later	16%

Notwithstanding the increase in the discount rate the existing $1,000 tax offset cap is to remain. The effect of the increased discount rate will be that to access the full amount of the offset SBE unincorporated income tax could be as low as $6,250 (in 2026/27) down from $20,000 this year (2015/16). Or, in other words, assuming no other income and marginal tax rates remain the same, SBE unincorporated income of around $42,000, down from around $87,000, will only be needed to access the full $1,000 discount.

Although justified on, and coinciding with, the staggered cuts in the corporate tax rate there is no assimilation between the respective benefits from these two measures. The tax offset is a permanent benefit in contrast to the reduction in the SBE company tax rate which can be "washed out" upon distribution of the profits in the form of dividends to shareholders facing a marginal tax rate greater than the company tax rate. Furthermore, any permanent benefit that may arise from the reduction in the company tax rate (say if the profits are retained, distributed to non-residents or distributed to low marginal tax rate residents) has no relationship to the size of the benefit presented by the unincorporated SBE discount.

Division 7A amendments

The increasing gap between the highest marginal rate of tax and the (SBE) company tax rate will place greater focus on tax planning surrounding access to the profits of private companies. Therefore, the amendments foreshadowed to Division 7A in the Budget (to apply from 1 July 2018) become of particular interest.

The amendments draw on the Board of Taxation's November 2014 post-implementation review of Division 7A. The Board developed a reform proposal it called the 'Amortisation Model'. Under this model, Division 7A loans would be repayable over a 10-year period, have reduced documentation requirements, and have greater flexibility in repaying interest and the principal. More particularly:

- There would be no requirement for a formal written agreement between the parties. However, written or electronic evidence showing that a loan was entered into must exist by lodgment day for the income year in which the loan was made.

- The statutory interest rate would be set at the start of the loan and fixed over the term of the loan. The rate would be the RBA's indicator lending rate for a small business; variable; other; overdraft for the month of May immediately before the start of the relevant income year.

- The maximum loan term would be ten years.

- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75% of the original loan by the end of year three;
  - 55% of the original loan by the end of year five;
  - 25% of the original loan by the end of year eight; and
  - 0% of the original loan (that is, fully repaid) by the end of year ten.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight and ten.
- Interest deductibility would be governed by existing income tax rules.

Failure to make the repayments by the end of the milestone period would result in the private company being taken to have paid a dividend to the borrower entity with the amount of the deemed dividend based on the amount of the shortfall in the payment required.

Complying 25-year loans would be grandfathered whilst all other pre-existing Division 7A loans would be transitioned to the new 10-year loans. In other words, existing complying 7-year loans would have their terms extended to the new maximum of 10 years.

The Amortisation Model has an additional feature that will assist trading trusts wishing to reinvest profits as working capital. This is a ‘business income election’ exemption, under which unpaid present entitlements (UPEs) owed to corporate beneficiaries will not be subject to Division 7A if the trustee makes a once-and-for-all election to forgo the general CGT discount concession on assets other than goodwill. The logic here is that had the funds been actually distributed to the company then any capital assets acquired with the funds would not have benefited from the general CGT discount. Retention of the discount for goodwill is justified on the basis that goodwill is, by its nature, an asset solely connected with using funds in a business – that is has an active rather than passive character. The acquisition of passive assets by the trust with the funds underlying the UPE is seen as particularly at odds with the Division 7A framework. Note that reliance on the indexed cost base (capped at September 1999) for assets acquired before 21 September 1999 would still be permitted notwithstanding the making of the election. SBEs might be extended transitional relief and allowed to still access the discount for assets acquired prior to the election date.

The Budget proposal also picks up on the Board's recommended safe harbour rules in the event of the use of corporate assets by entities associated with the company. These rules distinguish between depreciating and appreciating assets:

- Depreciating assets: a rental charge could apply, comprising a finance amount, a depreciation component and an amount for the asset's other operating costs.

- Appreciating assets (eg land and buildings): a usage charge could apply, calculated by multiplying the statutory interest rate by the asset's indexed value (which could be updated with an arm's length valuation every five years).

Additionally, the Budget also proposed adopting a self-correction mechanism. As recommended by the Board this mechanism would have the following features:

- Taxpayers could self-assess their eligibility for an exception to Division 7A (eg Division 7A loan) that will operate to reverse the effect of a prior deemed dividend.

- Eligibility for the exception will depend on the conduct that caused the deemed dividend being unintentional and that appropriate steps are taken to ensure that the parties are placed in the position they would have been in had the dividend not arisen (ie catch up payments are made to the company of interest and principal).

- A taxpayer who validly exercises self-correction may be liable for a penalty reflecting the degree of culpability. This "self-correction penalty" would likely be around 5%.

The rationale for introducing this mechanism is to address the current limitations of the Commissioner's discretion which is considered too inflexible.

The Board had also recommended a new approach to imposing and remitting administrative penalties on deemed dividends, to reduce the implicit additional penalty that can arise as a result of deemed dividends being unfranked.

Conclusion

Whilst the political battle rages on about just exactly what is a small business, consensus does seem to exist between the two major parties on the tax cuts for SBEs that meet the current $2m turnover threshold. It could also be expected that the Division 7A proposals should also enjoy bipartisan support as supplying more clarity and flexibility without raising any major integrity concerns. These changes will, obviously, be of great interest to private company clients.